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Office of the Comptroller of the Currency  
250 E Street, SW.  
Public Information Room, Mailstop 1-5  
Washington, DC 20219  
Attention: Docket No. 05-08  
Via Email: [regs.comments@occ.treas.gov](mailto:regs.comments@occ.treas.gov)

Robert E. Feldman  
Executive Secretary  
Federal Deposit Insurance Corporation  
550 17<sup>th</sup> Street, NW.  
Washington, DC 20429  
Attention: Comments  
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Ms. Jennifer J. Johnson  
Secretary  
Board of Governors of the  
Federal Reserve System  
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Washington, DC 20551  
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Via Email: [regs.comments@federalreserve.gov](mailto:regs.comments@federalreserve.gov)

Regulation Comments  
Chief Counsel's Office  
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1700 G Street NW.  
Washington, DC 20552  
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Via Email: [regs.comments@ots.treas.gov](mailto:regs.comments@ots.treas.gov)

**Re: Comments on Interagency Proposal on the Classification of Commercial Credit Exposures**

Dear Sirs or Madams:

Wachovia is grateful for the opportunity to comment on the Interagency Proposal on the Classification of Commercial Credit Exposures whereby a two-dimensional based framework would replace the current commercial loan classification system categories "special mention," "substandard," and "doubtful".

**The overall concept of the proposal is definitely an improvement over the current, one-dimensional regulatory rating system and – if designed properly – could provide a more accurate and reliable assessment of the true monetary risk in exposures. Further, a well-designed system could make the process of translating internal bank ratings to regulatory designations more transparent and consistent. However, Wachovia has concerns with the timing of this proposal in light of the significant resources currently associated with Basel II and Sarbanes-Oxley initiatives and with the approach of specifying a prescriptive grading system at the same time banks are being asked to develop Basel II grading systems that must meet quite rigorous standards in**

producing two-dimensional grades. Perhaps a better approach would be to permit banks with Basel-compliant grading systems to use input parameters from that system to assign credits to the various asset quality ratings. Less complex banks could continue to use today's system (possibly with some update), just as they will remain on the Basel I capital rules. Although more sophisticated risk assessments would provide some marginal benefit for these banks, it is not clear that such benefits would be sufficient to justify the implementation burden. Those who wish to opt in could develop compliant commercial grading systems and do so.

**While our preference is to utilize the Basel II grading system, we offer recommendations for improving the rules in the proposal if the Agencies choose to specify a grading system. We believe that the proposal in its current form lacks sufficient definitional guidance and would not differentiate risk in a uniform manner. Without additional refinements this could lead to inconsistent application.**

Specific comments on the above and other issues raised by the proposal follow in the attached Appendix and highlight our views with respect to elements of the proposal's overall approach, treatment of Asset Based Lending transactions, and treatment of guarantees. As noted in the proposal, the Agencies will need to review the existing classification guidance for specialized lending activities for such areas as commercial real estate lending, to reflect the proposed rating framework. Depending on additional Agency guidance, supplementary commentary on behalf of Wachovia may be necessary with regard to this area.

**In short, we believe that a move to a two-dimensional rating concept is clearly a step in the right direction, but recommend that it use grading systems developed for Basel II and that implementation be coordinated with the timing of Basel II.**

Wachovia appreciates the Agencies' interest in industry comments, and we would be pleased to further discuss potential changes and/or implementation timelines with the Agencies.

Sincerely,



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## **Appendix**

Note: Throughout this response, referenced page numbers correlate to the page numbers in the Federal register / Vol. 70, No. 58 / Monday, March 28, 2005 / Notices.

### **Overview**

The Proposal is based upon the concept of a Borrower Rating and a Facility Rating, with the required use of these ratings limited to loans considered to be of “Criticized” or “Classified” asset quality. The proposed Borrower Ratings are “Marginal,” “Weak,” and “Default.” Proposed Facility Ratings are “Remote Risk of Loss,” “Low Loss Severity,” “Moderate Loss Severity” and “High Loss Severity.” The assigned Borrower and Facility Ratings are mapped on a grid to determine an asset quality outcome of “Pass,” “Criticized” or “Classified.” Wachovia interprets the proposed rating concept as generally mirroring the current regulatory problem asset categories of “Special Mention,” “Substandard,” “Doubtful” and “Loss.” In our interpretation, a rating outcome of “Criticized” under the proposal would equate to a “Special Mention” rating under the current rating concept, with a grading outcome of “Classified” equating to the “Substandard,” “Doubtful,” and “Loss” ratings of the present system. The proposed Facility ratings address the degrees of potential loss severity previously encompassed by the “Doubtful” and “Loss” distinctions. The loss severity component of the proposed rating system is measured by comparing the current loan balance to the liquidation value of the collateral.

To ensure clarity, the Proposal should include the ability, when appropriate, to assign equivalent credit ratings to multiple exposures within a lending relationship when those exposures are cross-collateralized and the loan documents contain cross default language.

As noted previously, the overall concept of the Proposal is definitely an improvement over the current, one-dimensional regulatory rating system, and if designed properly, could provide a more accurate and consistent assessment of the true monetary risk in exposures. Wachovia has considerable experience in and detailed documentation of the application of such a multi-step asset rating concept, and much of the interagency proposal aligns to some degree with actual outcomes experienced and anticipated at Wachovia. In some instances, the proposal differs from Wachovia’s experience. Particularly, the presently proposed grade mapping does not always appear to provide a consistent alignment of rating and risk.

**Based upon experience and analysis, Wachovia recommends specific revisions to the proposal as follows.**

- A) Build on Basel II, including the implementation timelines thereof, thus allowing banks with Basel-compliant grading systems to use input parameters from that system to assign credits to the various asset quality ratings.**

**B) If the Agencies insist on developing a separate grading system for use in classifying credits, then provide a more consistent transition between grades. Marginal / low loss severity rated assets should receive a pass asset quality rating.**

Under the present Interagency Proposal, the following rating combinations/outcomes are prescribed (pg. 15686, Grid):

<u>Borrower Rating</u>	+	<u>Facility Rating</u>	=	<u>Asset Quality Rating</u>
Marginal		Remote Risk Of Loss		Pass
Marginal		Low Loss Severity		Criticized
Marginal		Moderate Loss Severity		Criticized
Marginal		High Loss Severity		Criticized
Weak		Remote Risk Of Loss		Pass
Weak		Low Loss Severity		Criticized (ABL only)
Weak		Low Loss Severity		Classified (Non-ABL)
Weak		Moderate Loss Severity		Classified
Weak		High Loss Severity		Classified
Default		Remote Risk Of Loss		Pass
Default		Low Loss Severity		Classified
Default		Moderate Loss Severity		Classified
Default		High Loss Severity		Classified

In addition to the above, the Proposal states that portions of Default assets rated either “Moderate” or “Low” Loss Severity are subject to potentially being considered “Loss”, with the assets written down to a conservative net realizable value. Entire facilities rated “High Loss Severity” are subject to potential write-off.

The mapping of asset quality ratings, in conjunction with the guidelines for asset write-downs, results in inconsistencies in grade treatment. For example, an exposure with a Marginal borrower rating and a Low Loss Severity facility rating would be rated Criticized. An exposure with a Default borrower rating and a Low Loss Severity facility rating could have up to 5% of the exposure considered “Loss”, with that amount written off. The remaining 95% of the exposure could then be rated “Pass”. In comparing the two grading scenarios, it is apparent that the proposed guidelines result in a more severe grading/capital outcome for the “better” of the two exposures. Additionally, it appears counterintuitive that a “Default” (i.e. Non-accrual) borrower could obtain a Pass rating, inferring a better risk profile than a fully performing Marginal rated borrower, simply by a write-off of 5% of exposure. It would be highly undesirable for banks to operate under rules that disproportionately weigh credit risk as noted in the example. A potential outcome could be industry-wide incidences of inappropriate credit decisions being made based upon an inconsistent grading outcome rather than upon the true risk of default/loss. Conversely, an institution basing its decision-making upon the perceived actual risk of default/loss could face a marketing disadvantage versus competitors opting for decision-making based upon a counter-intuitive grading outcome. It appears more appropriate for Marginal / Low Loss Severity exposure to be rated “Pass” rather than Criticized.

Wachovia also requests enhancement of the Proposal component regarding special grading treatment for qualifying Asset Based Lending (ABL) transactions (pg. 15685). Wachovia currently employs a statistically valid grading methodology that recognizes the risk mitigation provided by ABL loan structures, and welcomes the distinct consideration of those specialty loan structures within the overall

grading proposal. Concern arises in that the Proposal appears too restrictive and could result in inconsistent asset quality rating determination. In the current interagency proposal, qualifying ABL exposure with an otherwise “Weak” borrower grade and Low Loss Severity can receive a Criticized rating, rather than the Classified rating, which would apply to non-ABL exposures. This component of the Proposal appears directionally consistent with current bank practice and experience. However, the Proposal does not provide for such a grade enhancement for qualifying asset based exposures with a Marginal borrower rating and Low Loss Severity – such an exposure would receive the same grading outcome of criticized as in the weak borrower scenario. This grading inconsistency would result in equal risk assessments for exposures with differing degrees of default/loss risk. (See Examples 1 & 2 starting on page 8). **Wachovia encourages consistent degrees of grading improvement for qualifying ABL exposures - i.e. any qualifying ABL exposure should receive the same degree of grading improvement regardless of the borrower rating.** Weak / Low Loss Severity ABL exposures would continue to be rated Criticized as proposed, but unlike the Proposal, qualifying Marginal / Low Loss Severity ABL exposure should be rated Pass.

### C) Loss Severity Estimates Should be Wider

Wachovia’s statistical analysis of its existing loan portfolio and documented liquidation outcomes over several years does not support the proposed break points between the four facility ratings (pg. 15686, chart). The proposed Loss Severity demarcations: 5%; 5% to 30%; over 30%, appear arbitrary and are both more conservative than current regulatory treatment in some instances and more liberal in others. The use of a 5% hurdle for Low Loss Severity would severely restrict the actual ability for institutions to make use of that category. On the opposite end of the band, requiring full charge-off of exposures rated High Loss Severity seems overly conservative when the hurdle is only 30%. It is recommended that (a) wider percentage bands be set for each of the three Facility grade dimensions, and that (b) there be an option, at least for institutions with sophisticated, Basel-compliant portfolio tracking systems, that the facility grade loss ranges be based upon the institution’s historical loss experience (within well defined limits).

### D) Clarifications / refinements relative to the determination of Remote Risk of Loss for asset based exposures (pg. 15685, col. 1).

- Agree that, with strong controls and monitoring, debtor-in-possession (DIP) exposures could merit a Remote Risk of Loss rating.
- The Cash Dominion requirement should be defined as “the institution has either full cash dominion or loan-related documents grant the institution the *right* to cash dominion either at it’s discretion or upon the occurrence of specific events such as failure to achieve a specified minimum borrowing availability, failure to achieve a specific financial ratio, or specified non-financial triggers such as management actions or market changes”.
- **The 90-day collateral liquidation timeframe appears arbitrary and does not provide the flexibility required to maximize return in a liquidation scenario.** As an example, retail inventory often has varying liquidation timelines and recovery values dependent upon the time of year. A more effective collateral liquidation timeframe guideline would be “by the end of the next high season for the collateral in question, not to exceed 180 days. The liquidation value should be sufficient to cover all collateral carrying costs and any other related uses of cash throughout the liquidation horizon.”

- **The requirement for collateral valuation “within 60 days” should be revised.** Wachovia proposes that the guideline state “at least annual evaluations for non-fixed asset collateral, supplemented by summary valuation updates at a frequency commensurate with the volatility of the collateral, at a minimum of semi-annually. Examples of adequate annual and summary valuation sources can include external appraisals, invoices, accounts payable verifications, lender’s experience in liquidating similar assets, trade publications, etc.” For non-real estate fixed asset collateral, a valuation obtained at loan inception remains valid, subject to downward adjustments for depreciation and/or reduced marketability. Any increase in loan exposure based upon non-real estate fixed asset collateral would require a new evaluation. Real estate collateral would comply with Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) valuations requirements.
- Collateral “coverage” (pg. 15685, col. 1) sufficient to achieve a rating of Remote Risk of Loss would include the following, assuming substantial compliance with all other components of the guidelines:
  - Lendable net collateral value should be sufficient to meet all projected borrowing needs at all times over the next 12 months, including, in addition to working asset volume fluctuations, all cash expenditures not covered from operations. These may include interest, scheduled principal payments, cash taxes, and maintenance capital expenditures, planned, otherwise unfinanced discretionary capital expenditures and dividends. Generally, a monthly borrowing base schedule would be the basis for determination of net collateral value. However, in the case of borrowing base structures that are considerably more conservative than general practice and/or documented collateral value would justify, an institution may include “Suppressed Availability” (no consideration for suppressed fixed asset collateral). *Suppressed Availability is defined as any portion of potential borrowing capacity that could be provided within a properly structured and monitored borrowing base, but is excluded from the borrowing availability calculation via conservative loan structure. Examples would include otherwise justifiable availability that is restricted by the total line limit, inventory sublimits, conservative advance rate percentages, non-specific availability blocks, etc. Reserves for specific anticipated needs are not considered to represent suppressed availability. Examples include reserves for dilution, rent, stand-by letters of credit, etc.*
- Regardless of method of control of advance rates for fixed asset collateral, at least 70% of gross borrowing base availability should be derived from accounts receivable, inventory, cash and equivalents, creditworthy guarantors, letters of credit, buyback agreements and/or other similar, highly liquid sources.

**E) Clarification / refinements relative to the determination of Low Loss Severity for asset based exposures (pg. 15685, col. 1).**

- Consistent with the rating of otherwise classified ABL exposures with Low Loss Severity as Criticized, otherwise criticized ABL exposures with Low Loss Severity should be rated Pass.
- **Consistent with the response to the liquidation timeline for Remote Risk of Loss, a more appropriate collateral liquidation horizon for Low Loss Severity would be “within 12**

**months, unless customary and reasonable industry practices for the collateral in question prescribe a longer liquidation window.”** Instances of reasonable collateral liquidation horizons in excess of 12 months would be highly exceptional, but could be justified in limited instances. Collateral for which there is a ready market and minimal obsolescence risk, but for which either the size and/or cost of the collateral mandates an extended marketing period would qualify. Examples include heavy equipment, aircraft and other similar assets. Durable assets maintained in commercial operations would also be included within the extended liquidation category, depending upon the remaining useful lives of the assets and residual liquidation values. Furthermore, the presence of collateral for which optimum recovery would require a liquidation period in excess of the prescribed limits should not preclude a Low Loss Severity rating if the collateral in question is a nominal component of the total collateral pool.

- Collateral Valuation guidance consistent with that noted for Remote Risk of Loss.
- Cash Dominion guidance consistent with that noted for Remote Risk of Loss.
- In our opinion, collateral “coverage” (pg. 15685, col. 1) sufficient to achieve a rating of Low Loss Severity would include the following, assuming substantial compliance with all other components of the guidelines:
  - Net collateral value sufficient to meet all projected borrowing needs at all times over the next 6 months, including, in addition to working asset volume fluctuations, all cash expenditures not covered from operations. These may include interest, scheduled principal payments, cash taxes, and maintenance capital expenditures. Generally, a monthly borrowing base schedule would be the basis for determination of net collateral value. However, in the case of borrowing base structures that are considerably more conservative than general practice and/or documented collateral value would justify, an institution may include “Suppressed Availability” (no consideration for suppressed fixed asset collateral). Pre-approved overadvances are allowed, provided that they have a specified cure date within the next 6 months and meet a specific, reasonable need. Such overadvances should not result in a collateral coverage shortfall.
  - Exposures otherwise meeting the collateral control requirements for Remote Risk of Loss, but not meeting the cash flow projection requirement, would be considered Low Loss Severity.
  - Exposures otherwise meeting the collateral control requirements for Remote Risk of Loss, but from 30% to 50% reliant upon fixed asset collateral, would be considered Low Loss Severity.

#### **F) Definition of “Strong Monitoring Controls” and “Prudent Advance Rates”**

The Proposal for grade treatment of asset based loans alludes to requirements that the exposures in question have, in addition to cash dominion, strong monitoring controls and prudent advance rates. The Proposal is silent as to determination of what is considered “strong” and “prudent.”

In the absence of further guidance, it is inferred that exposures meeting the collateral coverage and convertibility requirements would, by inductive logic, meet the requirements for strong monitoring and prudent advance rates. In Wachovia’s opinion, “monitoring control” sufficient to achieve a rating of

Remote Risk of Loss would include, in addition to the previously noted statement regarding cash dominion:

- Periodic field examinations, generally once per year, but potentially varying from as frequently as quarterly to as infrequently as every three years, depending upon the stability of the borrower and of the collateral. For exposures that would otherwise be rated “Classified” in the absence of ABL coverage and monitoring, the minimum field examination frequency would be annual. Adequate field examinations would include cash tests, shipping tests, inventory counts and any other activities required for validation of reported asset values.
- Inventory valuation at loan inception / renewal, supplemented by periodic internal valuation updates utilizing the methods previously noted for collateral valuation “within 60 days.”
- Independent appraisals of fixed asset collateral at loan inception. Fixed assets comprising a nominal percentage of the collateral pool may be valued internally, at lender discretion.
- Advance rates for fixed asset collateral within a borrowing base should be adjusted at least annually, either by maintaining the initial advance rate percentage and updating the collateral value via external appraisals, or by amortizing the fixed asset collateral reliance on a schedule shorter than or matching the useful life of the assets.
- Client-prepared borrowing base certificates received within 25 days of each month-end, supplemented by accounts receivable agings and inventory detail as requested by the financial institution. Borrowing base certificates and supporting documents are required only when there are outstanding balances on the loan.

### **Grading Examples**

#### **Example 1: Asset Based Borrower A**

Borrower A has an asset based revolving line of credit. The borrower’s financial performance meets the definition of a “Marginal” borrower, with operating cash flow coverage of fixed charges slightly less than 1:1, but with full EBITDA coverage of interest expense.

The borrowing base is comprised predominately of accounts receivable and inventory, with fixed assets comprising 20% of the collateral pool. The lending institution has cash dominion, inventory is re-evaluated every 6 months, using a 12-month liquidation horizon. Both receivables and inventory are analyzed via semi-annual field examinations (with advance rate adjustments for dilution, slow moving inventory, etc). Fixed assets were evaluated at loan inception, and the lendable value of those assets is amortized on a schedule matching the useful life of the assets.

The unused borrowing base availability can fully meet cash flow deficits over the next 6 months, when it is anticipated that cash flow will improve to a positive fixed charge coverage position.

In this example, the exposure would be rated Criticized if structured as a typical commercial loan with a blanket lien upon the same collateral. However, the asset based structure and monitoring provides lower potential for both Default and Loss. The credit grading of the exposure should reflect this risk as well, with a Borrower grade of Marginal and a Facility rating of Low Loss Severity, for a final rating of Pass. (This grading outcome is not available in the methodology of the Interagency proposal.).

### **Example 2: Asset Based Borrower B**

Borrower B has an asset based revolving line of credit. The borrower is in the cyclical steel industry, and while sales are trending positive, a recent spike in raw material costs has placed a temporary strain on cash flow as the borrower carries higher inventory costs. The borrower has successfully passed along the higher costs to its customers without an impact to revenues, but a 3 month asset conversion cycle means that the borrower will not begin to see the benefit of those sales for 4 or 5 months. Financial performance meets the definition of a “Weak” borrower, with EBITDA insufficient to cover interest expense.

The borrowing base is comprised of accounts receivable and inventory, with an inventory sub-limit of 50% of committed exposure. The lending institution has cash dominion, inventory is re-evaluated every 3 months, using a 6-month liquidation horizon. Both receivables and inventory are analyzed via quarterly field examinations, with appropriate advance rate adjustments.

There is significant unused borrowing capacity within the borrowing base, sufficient to fully cover anticipated cash flow shortfalls over the next 12 months. Additionally, there is suppressed availability due to margined inventory value exceeding the sub-limit.

In this example, the exposure would be rated Classified if structured as a typical secured but unmonitored commercial loan. However, the conservative asset based structure and close monitoring provide ample collateral coverage at all times. As a result, the exposure has a Remote Risk of Loss and thus is graded “Pass.”

### **Example 3: Asset Based Borrower C**

Borrower C has an asset based revolving line of credit. The borrower is an importer of frozen shrimp, with sales trending positive and several long-term contracts in place. However, recently enacted foreign trade tariffs have created an indefinite increase in raw material costs, placing a strain on cash flow as the borrower both carries higher inventory costs and honors in-process contracts at tighter margins. As a majority of the industry was equally impacted, it is anticipated that the borrower will eventually be capable of passing along a majority of the higher costs to its customers. There will, however, be an impact to revenues, as the tariffs will lessen the pricing advantage importers enjoy over domestic suppliers. Financial performance meets the definition of a “Weak” borrower, with EBITDA insufficient to cover interest expense.

The borrowing base is comprised predominately of inventory, along with accounts receivable. There are no collateral sub-limits. The loan documents contain a springing cash dominion covenant, which has not been tripped. Inventory is re-evaluated annually, documented with both low and high season liquidation values. Both receivables and inventory are analyzed via quarterly field examinations, with appropriate advance rate adjustments.

Unused borrowing capacity has tightened recently, but the lending institution has enacted an availability block sufficient to cover 6 months of potential cash flow shortfalls.

In this example, the exposure would be rated Classified if structured as a typical secured but unmonitored commercial loan. However, the acceptable asset based structure and monitoring,

supplemented with the ability to perpetually maintain Suppressed Availability sufficient to bridge near-term cash needs (and a collateral liquidation period, if needed) provide sufficient collateral coverage to merit a Low Loss Severity facility rating and a credit grade of Criticized.

## **F) Guarantors**

The Framework Principles (pg. 15685, col.2) included within the Proposal state “When a facility is unconditionally guaranteed, the guarantor’s rating can be substituted for that of the borrower to determine whether a facility should be criticized or classified.” **This section should be expanded to include the potential for Pass ratings, and to provide guidance in the determining when and to what extent a particular guarantor can provide mitigation of Default / Loss.**

- In instances where the guarantor’s resources are sufficient, a Pass rated guarantor can reduce the potential for Default / Loss to a level comparable to stand-alone exposure rated Pass. In those instances, the exposure in question should be rated Pass. The determination of the guarantor grade should incorporate not only the guarantor’s direct obligations, but also the financial impact to the guarantor of providing the estimated level of support required to prevent default. As an example, a guarantor rated Pass may not have the capacity to maintain it’s own financial stability and provide the level of support needed to maintain borrower viability. In that case, the guarantor grade of Pass would not translate into a Pass borrower rating. On the other hand, a guarantor with both the ability and perceived willingness to support the borrower to the extent needed to maintain solvency could merit a remote Risk of Loss borrower rating regardless of the borrower’s stand-alone Borrower and Facility ratings.
- **Limited guarantees can provide Default / Loss mitigation, and should receive commensurate consideration in the rating system.**

### **Example - Limited Guarantee**

Borrower is a Special Purpose Company (SPC) owning a plane. The plane is collateral for a loan in the name of the SPC, and the plane’s current orderly liquidation value equals the loan outstandings. The borrower generates a nominal operating loss and does not fully cover scheduled debt service. There is a 40% limited guarantee by an entity with unencumbered liquid assets totaling 2x the borrower’s debt service shortfall. In this instance, the exposure in question receives a Marginal Borrower rating and a Remote Risk of Loss Facility rating.